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THE ELITE QUARTERLY – Taxation

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What's Inside This Issue

Instructions, Content Level, & Learning Objectives

Please read the content on pages 1-17, the exam questions on pages 18-20, and the exam instructions on page 21. Select the best answer for each exam question and record the answers either on the answer sheet on page 21 or online at www.cpelite.com.

The content level for this course material is "Update" and field of study classification is "Taxation". A general understanding of federal income taxation is the prerequisite for this course. No advance preparation is required. The ***Learning Objectives*** for this course are:

1. Identify details in connection with code section 163(j) interest expense.
2. Recall recent court decisions involving tax refunds and lookback periods.
3. Recall the connection between corporate loans and deductibility of related expenses.
4. Identify requirements associated with Rev. Proc 2019-33 and the ability to make a late bonus depreciation election.
5. Recall trends in taxpayer compliance concerning alimony payments received.
6. Identify risks related to trust fund taxes, including the Section 6672 penalty and requirements imposed on a "Responsible Person".

Key Terms in This Issue of *THE ELITE QUARTERLY*

[Item 1] Interest - any amount that is paid, received, or accrued as compensation for the use or forbearance of money under the terms of an instrument or contractual arrangement or that is treated as interest under the Internal Revenue Code or the regulations thereunder.
[Item 1] Floor plan financing - indebtedness that is used to finance the acquisition of motor vehicles held for sale or lease, and that is secured by the acquired inventory.
[Item 3] Congressional Intent – methodology by which the judiciary, when interpreting a case or law, will consider the legislature as they enacted legislation.
[Item 5] Expatriate - a person who ceases to be a tax resident in a country.
[Item 6] Federal Register - the official journal of the federal government of the United States that contains government agency rules, proposed rules, and public notices.
[Item 8] TIGTA – Treasury Inspector General for Tax Administration, established under the IRS Restructuring and Reform Act of 1998 to provide independent oversight of IRS activities.
[Item 9] Separation Agreement – A document that two individuals in a marriage use to divide their assets and responsibilities when preparing for separation or divorce.
[Item 10] Federal Tax Lien – the government's legal claim against a taxpayer's property when taxpayers neglect or fail to

pay a tax debt. The lien protects the government's interest in all of the taxpayer's property, including real estate, personal property and financial assets.

[Item 10] <u>Federal Tax Levy</u> - a legal seizure of the taxpayer's property to satisfy a tax debt.

[ITEM 1] Section 163(j) – Interest Expense

In this spirit of football season, we'll "kick-off" this quarter's newsletter with a deep dive on Section 163(j), Interest Expense reviewing the fundamentals including proposed regulations issued by the Treasury Department on Nov 26, 2018 [REG-106089-18]. First, let's tackle the basics…

Prior to the 2017 Tax Cuts and Jobs Act (TCJA), section 163(j) of the Internal Revenue Code applied only to certain interest paid or accrued by corporations. However, passage of the TCJA significantly changed the section 163(j) limitation. Generally, taxpayers can deduct interest expense paid or accrued in the taxable year. However, if section 163(j) applies, the amount of deductible business interest expense in a taxable year cannot exceed the sum of:

- the taxpayer's business interest income for the year;
- 30% of the taxpayer's adjusted taxable income (ATI) for the year; and
- the taxpayer's floor plan financing interest expense for the year.

For tax years beginning after 2017, this limitation applies to all taxpayers who have business interest expense, other than certain small businesses that meet the gross receipts test in section 448(c). A business generally meets the gross receipts test of section 448(c) when it is not:

- a tax shelter (as defined in section 448(a)(3)) and,
- has average annual gross receipts of $25 million or less in the previous three years.

For tax year 2019 and subsequent years, the $25 million amount will be adjusted for inflation.

<u>*Example*</u>

BigBucks Company has annual gross receipts for years 2015-2017 which were more than $25 million. Gross receipts in 2018 for BigBucks decreased enough to lower the average annual gross receipts for years 2016-2018 to below $25 million. Will BigBucks Co. be subject to the section 163(j) limitation when they file for the 2019 tax year?

<u>No.</u> Although they are subject to the section 163(j) limitation for the 2018 tax year, the limitation does not apply for the 2019 tax year. Any amount of business interest expense that was disallowed in 2018 due to the limitation is carried forward to 2019 and will no longer be subject to the limitation in 2019. Therefore, BigBucks Co. does not need to compute the section 163(j) limitation for the 2019 taxable year.

Additionally, the limitation does not apply to the following *<u>excepted</u>* trades or businesses.

- The trade or business of providing services as an employee;
- Certain real property trades or businesses that elect to be excepted;
- Certain farming businesses that elect to be excepted; and
- Certain regulated utility trades or businesses.

An eligible real property trade or business or farming business may elect to be an excepted trade or business by following the procedures outlined in §1.163(j)-9 of the proposed regulations, including the requirement to attach a statement to a timely filed federal income tax return (including any extensions) for the year of election (Revenue Procedure 2018-59).

An exempt small business is not permitted to make an election to be an excepted trade or business because that taxpayer is already not subject to the section 163(j) limitation. Once made, the election is generally irrevocable and binding on the trade or business for all succeeding years. See §1.163(j)-9 of the proposed regulations for certain circumstances where the election may no longer apply. This election statement must include the following information:

- The taxpayer's name, address, and social security number or employer identification number;
- A description of the electing trade or business, including the principal business activity code; and
- A statement that the taxpayer is making an election as a real property trade or business (under section 163(j)(7)(B) or as a farming business (under section 163(j)(7)(C)), as applicable.

Taxpayers making an election to be an excepted real property trade or business are also subject to a restriction on assets, specifically the method of depreciation. Assets that are held in the electing real property trade or business must be depreciated using the alternative depreciation system (ADS), and are not eligible for a bonus depreciation deduction under section 168(k). They include:

- Nonresidential real property;
- Residential rental property; and
- Qualified improvement property.

For those taxpayers making an election to be a farming business, any property with a recovery period of 10 years or more that are held in the electing farming business must be depreciated using ADS, and such property is not eligible for a bonus depreciation deduction under section 168(k).

<u>Definitions, Calculations and FAQ's</u>

As previously mentioned, the Section 163(j) limitation will impact many taxpayers going forward. As such, practitioners should have a firm understanding of terms within the code section along with an understanding of the actual limitation calculation.

Interest - is any amount that is paid, received, or accrued as compensation for the use or forbearance of money under the terms of an instrument or contractual arrangement or that is treated as interest under the Internal Revenue Code or the regulations thereunder. Interest also includes certain amounts that are closely related to interest such as substitute interest payments, debt issuance costs, loan commitment fees, and certain amounts that affect the economic cost of funds or yield of a borrowing or an interest-generating asset. Under an anti-abuse rule, certain amounts predominantly associated with the time value of money also may be treated as interest expense for purposes of section 163(j). Section 1.163(j)-1(b)(20) of the proposed regulations provides additional information on what constitutes interest under section 163(j).

Business interest expense - is any interest expense that is properly allocable to a trade or business. Floor plan financing interest expense is also considered business interest expense.

Floor plan financing interest expense - is interest paid or accrued on floor plan financing indebtedness. Floor plan financing indebtedness is indebtedness that is used to finance the acquisition of motor vehicles held for sale or lease, and that is secured by the acquired inventory. For example, if a taxpayer owns an automobile dealership and pays interest on a loan that is secured by the dealership's office equipment, then such interest is not deemed a floor plan financing interest expense.

Business interest income - is interest income that is includable in gross income and properly allocable to a trade or business.

Calculating Adjusted Taxable Income (ATI)

ATI is calculated by taking the taxable income for the taxable year as if section 163(j) does not limit any interest deduction, and then adding and subtracting from certain amounts for the taxable year:

Additions

Business interest expense; net operating loss deduction; deduction for qualified business income under section 199A; depreciation, amortization, or depletion deduction; capital loss carrybacks or carryovers; and any deduction or loss not properly allocable to a non-excepted trade or business.

Subtractions

Business interest income; floor plan financing interest expense; the lesser of (i) gain realized on sale or disposition of property or (ii) deductions for depreciation, amortization or depletion taken for such property during a tax year beginning after 2017 (and similar adjustments for sales or dispositions of property held by a partnership or member of a consolidated group upon the sale or other disposition of the partnership interest or stock of the member); and any income or gain that is not properly allocable to a non-excepted trade or business.

For taxable years beginning after 2021, deductions for depreciation, amortization, or depletion are not taken into account in calculating ATI.

Carryovers

The amount of business interest expense disallowed as a deduction in the current year under section 163(j) is carried forward to the next taxable year (a "disallowed business interest expense carryforward"). This disallowed business interest expense carryforward may be limited in the next taxable year if the section 163(j) limitation continues to apply.

Example

If a taxpayer is engaged in both an excepted trade or business and a non-excepted trade or business, how is the section 163(j) limitation determined?

Interest expense that is properly allocable to an excepted trade or business is not subject to the section 163(j) limitation. Similarly, the number of items of income, gain, deduction, or loss, including interest income that is properly allocable to an excepted trade or business, is excluded in determining the section 163(j) limitation. Therefore, the taxpayer should allocate tax items between excepted and non-excepted trades or businesses in order to determine the section 163(j) limitation.

Section 1.163(j)-10 of the proposed regulations provides special rules for allocating various tax items. Taxpayers must generally compare their basis in the assets used in excepted trades or businesses and the basis of assets used in non-excepted trades or businesses to determine what portion of interest expense and interest income to allocate to excepted trades or businesses. In limited cases, tracing of interest expense paid on certain nonrecourse debt may be available.

Partnerships and S corporations

The section 163(j) limitation is applied at the partnership level. As addressed earlier, the amount of deductible business interest expense in a taxable year cannot exceed the sum of the partnership's business interest income, 30% of the partnership's ATI, and the partnership's floor plan financing interest expense. Business interest expense that may be deducted upon application of the section 163(j) limitation is taken into account in determining the non-separately stated taxable income or loss of the partnership. Any business interest expense of the partnership that is disallowed upon application of the section 163(j) limitation is allocated to each partner in the same manner as the non-separately stated taxable income or loss of the partnership. This amount is called excess business interest expense.

A partner carries forward its share of excess business interest expense. In a succeeding taxable year, a partner may treat its excess business interest expense as business interest expense paid or accrued by the partner to the extent the partner is allocated excess taxable income or excess business interest income from the same partnership. Excess taxable income is the amount of ATI of the partnership that was in excess of what it needed to deduct its business interest expense, and excess business interest income is the amount by which business interest income exceeded business interest expense at the partnership level. Excess taxable income is allocated to each partner in the same manner as the non-separately stated taxable income or loss of the partnership. An allocation of excess taxable income to a partner increases the partner's ATI. Similarly, an allocation of excess business interest income to a partner increases the partner's business interest income. Once excess business interest expense is treated as business interest expense paid or accrued by the partner, such business interest expense is subject to the partner's section 163(j) limitation, if any.

S corporations apply the section 163(j) limitation at the S corporation level. Any business interest expense of the S corporation that is disallowed upon application of the section 163(j) limitation is not allocated to its shareholders, but is instead carried over at the S corporation level to its succeeding taxable years. An S corporation allocates any excess taxable income and excess business interest income to its shareholders on a pro-rata basis.

Section 1.163(j)-6 of the proposed regulations provides special rules and defines terms relating to the application of section 163(j) to partnerships and S corporations.

Consolidated Groups

The section 163(j) limitation applies at the consolidated return level, and a consolidated group has a single limitation. In calculating the limitation, a consolidated group's business interest expense and business interest income is, respectively, the sum of its members' business interest expense and business interest income. The consolidated group should calculate its ATI using the group's taxable income as determined under § 1.1502-11 without regard to any carryforwards or disallowances under section 163(j).

Foreign Corporations

With respect to Foreign Corporations, the section 163(j) limitation applies to a foreign corporation that is a controlled foreign corporation (CFC) within the meaning of section 957 (applying only if the foreign corporation has at least one United States shareholder that owns at least 10 percent of the vote or value of the foreign corporation, directly or indirectly, within the meaning of section 958(a)).

Generally, section 163(j) applies to a CFC in the same manner as those rules apply to a domestic C corporation. If a CFC is a partner in a partnership, the section 163(j) limitation applies to the partnership in the same manner as if the CFC were a domestic C corporation. Section 1.163(j)-7 of the proposed regulations provides rules for determining the amount of ATI and calculating the limitation for CFCs.

In addition, under §1.163(j)-8 of the proposed regulations, a foreign corporation that is engaged in a United States trade or business, may also be subject to section 163(j). In the case of foreign corporations engaged in a U.S. trade or business, the proposed regulations coordinate the application of section 163(j) with the rules limiting U.S. taxation to only that income effectively connected with that U.S. trade or business.

Other Considerations

The Proposed Regulations would apply to tax years ending after the date the Treasury decision adopting the regulations as final regulations is published in the Federal Register. Taxpayers and their related parties may, however, apply the Proposed Regulations to a tax year beginning after December 31, 2017, so long as the taxpayers and their related parties consistently apply the Section 163(j) Proposed Regulations, and if applicable, other relevant Proposed Regulations to those tax years. Thus, unlike some of the other proposed regulations issued in response to the TCJA, the Proposed Regulations would not be retroactive to the date that the TCJA was enacted.

Practitioners should also note that Rev. Proc 2018-59 was released on Nov 27, 2018 which details a "safe harbor" to allow taxpayers to treat certain infrastructure trades or businesses as "real property trades or businesses" solely for purposes of qualifying as an electing real property trade or business for purposes of the business interest limitation under section 163(j).

[ITEM 2] Social Security

We'll side step taxes for a moment to discuss, what many consider is a pressing concern, the solvency of Social Security. The concepts of solvency, sustainability, and budget impact are common in discussions of Social Security, but are not well understood.

Where do we stand?

- Currently, the Social Security Board of Trustees projects program cost to rise by 2034 so that taxes will be enough to pay for only 77 percent of scheduled benefits.
- This shortfall is basically stable after 2034
- Adjustments to taxes or benefits that offset the effects of lower birth rates may restore solvency for the Social Security program on a sustainable basis for the foreseeable future.
- As Treasury debt securities (trust fund assets) are redeemed in the future, they will just be replaced with public debt. If trust fund assets are exhausted without

reform, benefits will necessarily be lowered with no effect on budget deficits.

With the current 12.4 percent payroll tax rate, along with additional revenue from federal income taxation of benefits, the OASDI program has been taking in more tax revenue than it has spent providing benefits for more than two decades. However, this favorable cash flow will be changing in the future as the large baby boom generation, born from 1946 through 1965, moves into retirement. The oldest people in this generation have already reached early retirement age (62), and the transfer of this generation from working age to retirement age will continue for the next 20 years. The substantial increase in the cost of the OASDI program from 2010 to 2030, both as a percent of taxable payroll and GDP, is founded in an even more basic shift in our economy: the change in the ratio of beneficiaries to the number of workers.

One useful way to describe the effect of the change in the aged dependency ratio and the resulting effect on the ratio of beneficiaries to workers is to consider the implied number of workers per beneficiary. For the past 35 years, there have been about 3.3 workers per beneficiary (consistent with the ratio of 30 beneficiaries per 100 workers). After 2030, the ratio will be two workers per beneficiary (consistent with 50 beneficiaries per 100 workers).

With the average worker benefit currently at about $1,000 per month, 3.3 workers would need to contribute about $300 each per month to provide a $1,000 benefit. But after the population age distribution has shifted to have just two workers per beneficiary, each worker would need to contribute $500 to provide the same $1,000 benefit.

Thus, in order to meet increased Social Security costs, substantial change will be needed. The intermediate projections of the 2009 Trustees Report indicated that if we wait to take action until the combined OASDI trust fund becomes exhausted in 2034, benefit reductions of around 25 percent or payroll tax increases of around one-third (a 4 percent increase in addition to the current 12.4 percent rate) will be required. Past legislative changes for Social Security suggest that the next reform is likely to include a combination of benefit reductions and payroll tax increases.

Because the large shift in the cost of the OASDI program is not due to increasing life expectancy, it is not clear that increasing the Normal retirement age should be the principal approach for restoring long-term solvency. Increasing the unreduced retirement age beyond 67 is one option that may be considered, given that the population may be healthier in the future and able to work to an older average age.

However, this raises the question of the adequacy of monthly benefit levels. After the Normal Retirement Age (NRA) reaches 67, those persons claiming benefits at age 62 will receive only 70 percent of the unreduced benefit level. Further increase in the NRA would decrease the adequacy of monthly benefits at age 62, and at all other ages, even further.

There is no one clear solution to the problem of increased cost for retirees because of fewer workers available to support the retirees, which in turn is caused by lower birth rates. This issue is not specific to Social Security, but also affects Medicare as well as many other private and public retirement income systems. The decline in birth rates has been far more dramatic in Japan and many European countries that are struggling with the effects of aging populations because of declines in birth rates even more severe than in the United States. Birth rates that averaged over three children per woman during the baby boom period (1946–1965) dropped to just two children per woman by 1970 and have remained at about that level since that time. Considering even longer historical periods helps in understanding the significance of the drop-in birth rates in the United States. It may be surprising to see how high birth rates were back in 1875 (over four children per woman) and how much they dropped by 1925 (to three children per woman). Reductions in death rates during infancy and early childhood help explain much of the longer-term decline in birth rates. Before 1900, the probability that a newborn would survive to age 5 or 10 was far below 100 percent.

Thus, in order to have a family with a desired number of children surviving to adulthood, more births were required in the past. Adjusting birth rates to include only those children who survive to age 18 results in fairly flat total fertility rates near three children per woman from 1875 through 1925. From 1926 through 1965, this adjusted total fertility rate was still about 2.7 births per woman, on average, including both the temporary low-birth period of the Great Depression and World War II, and the temporary high-birth period after World War II. After 1965, however, the total fertility rate shifted to a new level around two children per woman.

It is this apparently permanent shift to lower birth rates in the United States that is the principal cause of our changing age distribution between 2010 and 2030 and the resulting shift in the ratio of beneficiaries to workers.

Trends tell a story. Anyone receiving W-2 wages (or tax practitioners!) can clearly feel the impact from increases in the Social Security Wage Base, year after year. The current level for 2019 is $132,900, nearly double the amount from tax year 2000. Wage base limits, the Social Security tax rate, the Medicare tax rate….we may very well experience an increase in all three. Experts rightly argue that a rise in the percentage rate (currently 6.2 %) for social security would harm individuals on the lowest income rungs of the economic latter. With that said, we may very well see a decoupling of employee and employer rates, with employers taking on a larger burden of this contribution. Time will tell.

[ITEM 3] Borenstein v. Commissioner

In an issue of first impression, the Second Circuit court recently reversed a Tax Court decision and held that the lookback period in Sec. 6512(b)(3) amounts to three years when no return is filed, removing a "six-month black hole" created by the Tax Court. The Second Circuit thus sided with a taxpayer who overpaid her taxes and later filed for a refund.

Facts

On April 15, 2013, Roberta Borenstein was granted a six-month extension to file her 2012 federal income tax return. By that date, she had made income tax payments for 2012 of $112,000. Borenstein failed to file her return. On June 19, 2015, the IRS sent her a statutory notice of deficiency stating that she owed $1,666,463 in income taxes and $572,577 in penalties for the 2012 tax year. On Aug. 29, 2015, Borenstein filed her late tax return and reported a tax liability of $79,559, resulting in an overpayment of $32,441. On Sept. 16, 2015, Borenstein filed a petition with the Tax Court calling for a redetermination of her 2012 tax deficiency along with a refund of her overpayment. Later, Borenstein and the IRS stipulated that the correct amount of the overpayment was $32,441.

The Tax Court ruled that it lacked jurisdiction. The court determined that under Sec. 6512(b)(3), Borenstein was entitled to a two-year lookback period for any refund, and since the overpayment occurred more than two years prior to the mailing of the statutory notice of deficiency, the court lacked jurisdiction to order a refund. On appeal, Borenstein argued that the Tax Court adopted an interpretation of Sec. 6512(b)(3) that is inconsistent with its plain language and congressional intent.

Issue

The Tax Court has limited jurisdiction under Sec. 6512(b) to order refunds or credits for overpayments. Lookback periods limit how far into the past the Tax Court may reach to remedy overpayments by refund or credit. A taxpayer who files a return and is issued a notice of deficiency within three years after that filing is entitled to a lookback period of at least three years. Prior to an amendment of Sec. 6512(b), a taxpayer who was issued a notice of deficiency before the filing of a return was entitled to a two-year lookback period. Congress sought to extend the lookback period available by providing in Sec. 6152(b)(3) that if a notice of deficiency is mailed "during the third year after the due date (with extensions) for filing the return," and if no return was filed before the notice of deficiency was mailed, the applicable lookback period is three years.

Borenstein argued that "with extensions" extends the third year after the due date by six months, so the notice was mailed during the third year, and, therefore, the applicable lookback period should be three years. The Tax Court ruled that "with extensions" delays the beginning of the "third year after the due date" by six months, meaning that Borenstein's notice of deficiency was mailed prior to the beginning of the third year, allowing for a two-year lookback period. The Tax Court said it lacked jurisdiction to order a refund.

On appeal, Borenstein argued that the Tax Court's interpretation of Sec. 6512(b)(3), which limits its jurisdiction to order refunds or credits of overpayments, is unreasonable and inconsistent with congressional intent.

Holding

The Second Circuit reversed the judgment of the Tax Court and remanded for the entry of judgment for Borenstein. The court stated that it was clear that Congress's intent was to eliminate the distinction between filers and nonfilers in that third year, but the Tax Court created a "black hole" into which the taxpayer loses a right to claim a refund that would have reopened later had the IRS issued the notice of deficiency.

The Second Circuit reasoned that its conclusion was supported by the long-standing canon of construction that where "the words of a tax statute are doubtful, the doubt must be resolved against the government in favor of the taxpayer," citing Exxon Mobil Corp., 689 F.3d 191, 199—200 (2d Cir. 2012) (quoting Merriam, 263 U.S. 179, 188 (1923)).

The Second Circuit concluded that the interpretation adopted was consistent with the language of Sec. 6511(b)(2)(A), which provides for a lookback period equal to three years plus the period of any extension of time for filing the return. In this case, the notice of deficiency, mailed 26 months after the due date, was mailed during the third year, and, therefore, the Tax Court had the jurisdiction to look back three years, which would reach the due date and allow the taxpayer to recover her overpayment.

[ITEM 4] S corp. expenses not personally deductible by shareholder as a sole proprietor

On March 7th, a US district court in Rhode Island granted summary judgment denying an attorney's claim for reimbursement of assessed taxes, penalties, and fees because he was not entitled to the disallowed deductions claimed on his individual tax return. It held that there was no clear evidence that he operated his law practice as a sole proprietorship separate from an S corporation that retained cases. Thus, he was not entitled to deduct on his individual return costs related to those cases or bonus payments he made to legal secretaries for work associated with the corporation, the court held.

Facts

In 1999, David Morowitz incorporated his law practice, the Law Office of David Morowitz Ltd., as an S corporation. The corporation reported all its income and expenses as an S corporation through 2009. At that time, Morowitz brought Patrick Barry into the corporation as a new shareholder and changed the corporation's name to Morowitz & Barry Ltd. He did not dissolve the original corporation, amend its corporate structure, or change its federal employer identification number (EIN).

In conjunction with the name change, Morowitz and Barry entered into a shareholder agreement segregating "[f]ees earned and monies paid on Mr. Morowitz's pre-existing cases" that would not belong to Morowitz & Barry. However, funds earned from the preexisting cases flowed through an account of the S corporation. In addition, the preexisting clients had executed retainers solely with the Law Office of David Morowitz and did not sign a new retainer agreement with either Morowitz & Barry or Morowitz individually.

In 2010, Morowitz & Barry operated using the same EIN and filed as an S corporation. However, Morowitz filed a Form 1040, Schedule C, Profit or Loss from Business, claiming deductions as a sole proprietor with regard to costs of preexisting cases paid out of the S corporation's bank account. Also, he claimed a deduction for $15,000 that he personally paid as bonuses to the S corporation's legal secretaries for work performed on a preexisting case. The IRS denied each of the deductions; Morowitz paid the assessment and brought a refund claim in the District of Rhode Island. The government filed for summary judgment.

Issues

Morowitz contended the payments he made for the preexisting cases were unrelated to the corporation but were from a separate sole proprietorship and that Morowitz & Barry, while technically not a new entity, reflected his intent to form a new firm.

In Moline Properties, Inc., 319 U.S. 436 (1943), the Supreme Court held that a corporation exists for tax purposes if it is formed for a business purpose or carries on a business activity. The court stated that when a taxpayer chooses the advantages of incorporation to conduct business, it must also accept the tax disadvantages. In National Alfalfa Dehydrating & Milling Co., 417 U.S. 134 (1974), the Supreme Court found that taxpayers are free to organize their business as they choose, but they must accept the tax consequences of their choice, even if not intended, and may not enjoy the benefit of another choice not selected.

Holding

The court granted summary judgment to the government, holding that there was no clear evidence that Morowitz operated a law practice as a sole proprietorship separate from the S corporation. It noted the practice had continued to elect to file as an S corporation after its name change and the addition of a shareholder, and that it continued to operate under the same EIN.

The court further held that Morowitz did not individually pay the costs for the preexisting cases out of the corporation's account, as he did not operate a business separate from the S corporation. Citing the holding in Grothues, T.C. Memo. 2002-287, that a shareholder's payments of a corporation's expenses are a loan or contribution of capital to the corporation, and, if deductible, are deductible by the corporation, as opposed to by the shareholder, the Tax Court held that Morowitz was not entitled to personal deductions for the costs of the preexisting cases retained and expensed through the S corporation.

[ITEM 5] IRS offers expatriate tax relief

Certain individuals who expatriate from the United States may obtain relief from the exit tax of Sec. 877A and other outstanding tax liabilities, under procedures the IRS outlined September 9th on its website and announced in News Release IR-2019-151.

The relief applies to individuals who relinquished or will relinquish their U.S. citizenship after March 18, 2010, and meet a number of other criteria. Native-born or naturalized U.S. citizens generally may voluntarily relinquish their citizenship for reasons and under procedures listed at 8 U.S.C. Section 1481(a).

Under the Code, expatriates must comply with all federal tax requirements for the year of expatriation and for the five immediately prior tax years. In addition, Sec. 877A imposes a tax on “covered expatriates” that deems most property as sold for its fair market value on the day before the day of expatriation. The resulting net gain over $725,000 (for 2019) is includible in their income. A covered expatriate is one who, under Sec. 877(a):

- Has an average annual net income tax liability in the five tax years ending before the date of expatriation of more than a specified amount ($168,000 for 2019);
- Has a net worth of $2 million or more; or
- Cannot certify under penalty of perjury that he or she has met all applicable tax requirements for the five preceding tax years or fails to submit evidence of compliance the IRS may require. This certification can be made with Form 8854, Initial and Annual Expatriation Statement.

In other words, even expatriates with income tax liabilities and net worth's below these thresholds may still be covered expatriates if they cannot make the certification.

Under the relief procedures announced through IR-2019-151, individuals who meet specified requirements will not be considered covered expatriates for purposes of Sec. 877A and will not be liable for any unpaid taxes and penalties for the year of expatriation and previously, the IRS stated. As noted above, the expatriation must have occurred after March 18, 2010.

Also, for the six tax years at issue (the year of expatriation and the five immediately prior years), any failure to file required tax returns and pay taxes and penalties for the years at issue must have been due to the taxpayer's nonwillful conduct. Required tax returns include income, gift, and information returns (the latter including Form 8938, Statement of Specified Foreign Financial Assets), and FinCEN Form 114, Report of Foreign Bank and Financial Accounts, commonly known as FBAR. Nonwillful conduct is that which is due to negligence, inadvertence, mistake, or a good-faith misunderstanding of legal requirements.

In addition, to be eligible for relief, the individual must:

- Have no filing history as a U.S. citizen or resident (not including Form 1040NR, U.S. Nonresident Alien Income Tax Return, under a good-faith but mistaken belief that the individual was not a U.S. citizen);
- Meet the above income tax liability limits for covered expatriates for the period of five tax years ending before the date of expatriation and meet the $2 million-net-worth limit at the time of expatriation and when applying for the relief;
- Have an aggregate tax liability of no more than $25,000 for the six tax years at issue (after application of all applicable deductions, exclusions, exemptions, and credits, including foreign tax credits, but excluding penalties, interest, and the exit tax of Sec. 877A); and
- Agree to complete and submit all required federal tax returns for the six tax years at issue, including all required schedules and information returns.

The IRS is offering these procedures without a specific termination date. The IRS will announce a closing date prior to ending the procedures. Individuals who relinquished their U.S. citizenship any time after March 18, 2010, are eligible so long as they satisfy the other criteria of the procedures.

In addition, these procedures are only available to individuals. Estates, trusts, corporations, partnerships and other entities may not use these procedures. The IRS provides answers to 23 frequently asked questions about the relief and several examples at irs.gov.

REVIEW QUESTIONS AND SOLUTIONS

1. Section 163(j) of the Internal Revenue Code has been materially modified with the passage of the TCJA. To the extent that this code section applies to a taxpayer, the deductible interest expense (in a given year) that the taxpayer could claim cannot exceed ___________.
   a. The taxpayer's business interest income plus 30% of the taxpayer's adjusted taxable income plus the taxpayer's floor plan financing interest expense
   b. The taxpayer's business interest expense plus 30% of the taxpayer's adjusted taxable income plus the taxpayer's floor plan financing interest expense
   c. The taxpayer's business interest expense plus 30% of the taxpayer's adjusted taxable income plus the taxpayer's floor plan financing indebtedness

2. Which of the following is true in connection with projections developed by the Social Security Board of Trustees?
   a. Program costs are expected to rise, but scheduled benefits should remain at 100%.
   b. A rise in birthrates will generate additional cash inflows for the program.
   c. Program costs will continue to rise so that by 2034, tax revenues will only be enough to pay for 77% of scheduled benefits.

3. Which of the following is not an excepted trade or business in connection with IRC Section 163(j)?
   a. Certain trades or businesses organized as an S-Corp.
   b. Certain farming businesses that elect to be excepted.
   c. Certain Real Property businesses that elect to be excepted

4. Borenstein v. Commissioner is a court case involving____________.
   a. Payments made in connection with an alimony dispute
   b. Lookback periods and a taxpayer's right to receive a refund for overpaid taxes
   c. Non receipt of a statutory notice of deficiency

5. The Supreme Court has held, in past court case decisions that ______________.
   a. a corporation exists for tax purposes if it is formed for a business purpose or carries on a business activity
   b. taxpayers are free to organize their business as they choose, but they must accept the tax consequences of their

choice, even if not intended, and may not enjoy the benefit of another choice not selected
c. Both a & b

6. Certain individuals who expatriate from the United States may obtain relief from the exit tax of Sec. 877A and other outstanding tax liabilities, under procedures outlined by the IRS. Sec. 877A imposes a tax on "covered expatriates" that deems most property as sold for its fair market value on the day before the day of expatriation. A covered expatriate would include which of the following individuals?
   a. An individual with an average annual net income tax liability in the five tax years ending before the date of expatriation of more than a specified amount ($168,000 in 2019).
   b. An individual with a net worth of more than $3 million.
   c. An individual who has filed Form 8854.

Solutions

1. **[a] Correct -** For tax years beginning after 2017, this limitation applies to all taxpayer's who have business interest expense, other than certain small businesses that meet the gross receipts test in section 448(c).
   [b] Incorrect – The taxpayers business interest income, not expense, is considered in this calculation.
   [c] Incorrect – Floor plan financing interest expense is considered in this calculation. Floor plan financing indebtedness is indebtedness that is used to finance the acquisition of motor vehicles held for sale or lease, and that is secured by the acquired inventory.

2. **[a] Incorrect –** Currently, the Social Security Board of Trustees projects program cost to rise by 2034 so that taxes will be enough to pay for only 77 percent of scheduled benefits.
   [b] Incorrect – Adjustments to taxes or benefits that offset the effects of the lower birth rate may restore solvency for the Social Security program on a sustainable basis for the foreseeable future.
   [c] Correct – As Treasury debt securities (trust fund assets) are redeemed in the future, they will just be replaced with public debt. If trust fund assets are exhausted without reform, benefits will necessarily be lowered with no effect on budget deficits.

3. **[a] Correct-** An exception does exist for those trade or businesses that provide services as an employee.
   [b] Incorrect – Additionally, certain regulated utility trades / businesses would be excepted.
   [c] Incorrect – The election must include a statement that the taxpayer is making an election as a real property trade or business (under section 163(j)(7)(B)).

4. **[a] Incorrect -** The Second Circuit reversed the judgment of the Tax Court and remanded for the entry of judgment for Borenstein and her claim of refund.
   [b] Correct - The crux of the dispute revolved around the lookback period and whether the tax court could reach to remedy overpayments by refund or credit.
   [c] Incorrect - Receipt of the notice of deficiency was not questioned in this matter.

5. **[a] Incorrect –** This is only partially true. The referenced case is Moline Properties, Inc., 319 U.S. 436 (1943).
   [b] Incorrect – This is only partially true. The referenced case is National Alfalfa Dehydrating & Milling Co., 417 U.S. 134 (1974)
   [c] Correct - Each term, approximately 7,000-8,000 new cases are filed in the Supreme Court.

6. **[a] Correct –** In addition, an individual who has a net worth of $2 million or more would also be a covered expatriate
   [b] Incorrect – an individual who has a net worth of $2 million or more would also be a covered expatriate
   [c] Incorrect – Individuals who cannot certify under penalty of perjury that he or she has met all applicable tax requirements for the five preceding tax years or fails to submit evidence of compliance the IRS may require would be considered a covered expatriate. Form 8854, Initial and Annual Expatriation Statement can be used to claim this certification.

[ITEM 6] Regulations clarify bonus depreciation treatment

On September 13th, the IRS issued final regulations (T.D. 9874) and new proposed regulations (REG-106808-19) governing the 100% bonus depreciation deduction under Sec. 168(k). The final regulations finalize proposed regulations issued in August 2018 (REG-104397-18) with some changes in response to comments.

REG-106808-19 contains new provisions not addressed previously. Both sets of regulations have been posted to IRS.gov prior to their official publication in the Federal Register.

Sec. 168(k) was amended to increase the bonus depreciation percentage from 50% to 100% for qualified property and to modify the definition of property that is considered to be qualified. The TCJA allows businesses to immediately deduct 100% of the cost of eligible property in the year it is placed in service, through 2022. The amount of allowable bonus depreciation is then phased down over four years: 80% will be allowed for property placed in service in 2023, 60% in 2024, 40% in 2025, and 20% in 2026. (For certain property with long production periods, the above dates will be pushed out a year.) Bonus depreciation is also allowable for specified plants planted or grafted after Sept. 27, 2017, and before Jan. 1, 2027.

Final regulations

The final regulations adopt the August 2018 proposed regulations with some modifications. They provide operational rules and address how to compute additional bonus depreciation and how to make elections under Sec. 168(k). They provide clarifying guidance on the requirements that must be met for property to qualify for the deduction under Sec. 168(k), including used property.

The final regulations provide rules for qualified film, television, and live theatrical productions. They also clarify how the basis of property that is subject to the alternative depreciation system is determined when it otherwise qualifies for bonus depreciation.

Although the IRS declined to remove the term “predecessor” from the final regulations’ definition of used property, it did decide to define the term in the final regulations. Therefore a predecessor is defined as (1) the transferor of an asset to a transferee in a transaction to which Sec. 381(a) applies; (2) a transferor of an asset to a transferee in a transaction in which the transferee’s basis in the asset is determined, in whole or in part, by reference to the basis of the asset in the hands of the transferor; (3) a partnership that is considered as continuing under Sec. 708(b)(2); (4) the decedent, in the case of an asset acquired by an estate; or (5) a transferor of an asset to a trust.

The final regulations are effective for qualified property placed in service (or planted or grafted, as applicable) during tax years that include the date they are published in the Federal Register. However, taxpayers may elect to apply the final regulations to qualified property placed in service (or planted or grafted, as applicable) after Sept. 27, 2017, during tax years ending on or after Sept. 28, 2017, provided the taxpayer consistently applies all the rules in the final regulations.

Proposed regulations

The proposed regulations contain guidance on (1) certain property not eligible for the additional first-year depreciation deduction; (2) a de minimis–use rule for determining whether a taxpayer previously used property; (3) components acquired after Sept. 27, 2017, of larger property for which construction began before Sept. 28, 2017; and (4) other aspects not dealt with in the August 2018 proposed regulations. The proposed regulations also withdraw and repropose rules regarding how the used property acquisition requirements apply to consolidated groups and to a series of related transactions.

The proposed regulations will be effective upon their publication as final regulations in the Federal Register; however, taxpayers may choose to rely on them, in their entirety, for qualified property placed in service (or planted or grafted, as applicable) after Sept. 27, 2017, during tax years ending on or after Sept. 28, 2017.

[ITEM 7] Rev. Proc. 2019-33

Continuing with our discussion of depreciation, we also have the recent publication of Rev. Proc. 2019-33; which will allow taxpayers to revoke or make late bonus depreciation elections for property acquired after Sept. 27, 2017 and placed in service or planted or grafted, as applicable, during a taxable year that includes Sept. 28, 2017. This relief is being granted in response to comments received about the Sec. 168(k) proposed regulations issued in August 2018 (REG-104397-18). After the August 2018 proposed regulations were issued, some taxpayers requested relief to make late elections for property placed in service during tax years that included Sept. 28, 2017, because they had already filed their federal returns for that tax year before the proposed regulations were issued or did not have time to analyze the effect of the proposed regulations and make a timely election.

Sec. 168(k) was amended by the law known as the Tax Cuts and Jobs Act (TCJA), P.L. 115-97, to increase the bonus depreciation percentage from 50% to 100% for qualified property and to modify the definition of property that is considered to be qualified. The TCJA allows businesses to immediately deduct 100% of the cost of eligible property in the year it is placed in service, through 2022. The amount of allowable bonus depreciation is then phased down over four years: 80% will be allowed for property placed in service in 2023, 60% in 2024, 40% in 2025, and 20% in 2026. (For certain property with long production periods, the above dates will be pushed out a year.) Bonus depreciation is also allowable for specified plants planted or grafted after Sept. 27, 2017, and before Jan. 1, 2027.

The TCJA also removed the rule that made bonus depreciation available only for new property and extended the period in which certain other property (including plants and films, television, and live theatrical productions) will qualify for 100% depreciation. These new rules generally apply retroactively to property acquired or placed in service after Sept. 27, 2017 (the TCJA was enacted Dec. 22, 2017).

Rev. Proc. 2019-33 allows a taxpayer to make a late election, or to revoke an election, under Sec. 168(k)(5), (7), or (10) for certain property acquired by the taxpayer after Sept. 27, 2017, and placed in service or planted or grafted, as applicable, by the taxpayer during its tax year that includes Sept. 28, 2017. Sec. 168(k)(5) allows a taxpayer to elect to deduct additional first-year depreciation for certain plants. Sec. 168(k)(7) allows a taxpayer to elect not to deduct additional first-year depreciation for any class of qualified property placed in service by the taxpayer during the tax year to which the election applies. Sec. 168(k)(10) allows a taxpayer to elect to deduct 50%, instead of 100%, additional first-year depreciation for certain qualified property.

Taxpayers may make the late elections or revocations of elections provided in the revenue procedure by filing amended returns or, for taxpayers that are partnerships subject to the centralized partnership audit regime, by filing an administrative adjustment request, for the 2016 tax year or the 2017 tax year before the taxpayer files its federal tax return for the first tax year succeeding the 2016 tax year or the 2017 tax year.

In the alternative, taxpayers may file a Form 3115, Application for Change in Accounting Method, with the taxpayer's timely filed federal tax return for the first, second, or third tax year succeeding the 2016 tax year or the 2017 tax year. Late elections or revocations under this revenue procedure will be treated as automatic changes in method of accounting with a Sec. 481(a) adjustment only during this limited period of time.

The IRS handed taxpayers a gift of additional time to analyze bonus depreciation elections for certain qualified property. Practitioners should look at which clients may have been impacted and reconsider any prior treatment of certain bonus depreciation choices.

[ITEM 8] Alimony tax gap swells to $3.2 billion

A recent report issued by the Treasury Inspector General for Tax Administration (TIGTA) highlighted discrepancies between the amount of alimony deducted by payers and the amount reported as income by its recipients. The report shows that this amount increased by 38% in six years, now at $3.2 billion for tax year 2016, (TIGTA Rep't No. 2019-40-048 (8/719).

TIGTA performed the audit to follow up its 2014 report on the alimony tax gap in which it found a $2.3 billion alimony tax gap for tax year 2010. Despite the earlier findings and recommendations, most of which the IRS accepted more than five years ago, TIGTA stated in its latest report that the IRS still lacked sufficient systemwide processes to identify and address alimony discrepancies and "has yet to adequately address the substantial compliance gap" they represent.

For alimony payable under separation agreements or divorce decrees executed on or before Dec. 31, 2018, alimony is deductible by the payer and includible in income of the recipient. For agreements and decrees executed subsequently, under the TCJA, alimony is neither deductible nor includible in income, except alimony paid under earlier agreements or decrees legally modified after Dec. 31, 2018, specifically to comply with the TCJA repeal.

For tax year 2016, TIGTA analyzed 569,978 returns claiming alimony deductions totaling nearly $13 billion. The amount of alimony reported as income on 284,053 returns yielded the $3.2 billion discrepancy. Some returns that should have reported income reported none or less than the corresponding deduction, or were not filed at all. Of the returns that did report alimony income, 175,820 reflected a difference between the income amount and the associated deduction, for a net total discrepancy of $1.6 billion. The unreported income resulted in an apparent understated tax liability totaling more than $248 million for the tax year.

Taxpayers claiming an alimony deduction are required to provide the tax identification number (TIN) of the recipient, and for 54,560 of the deduction returns, reflecting $1.5 billion in deductions, TIGTA found no return filed for the corresponding TIN (noting that some may not have been required to file a return).

For another 2,168 deduction returns, the recipient's TIN was invalid. TIGTA found that the IRS lacks a consistent process for validating these TINs and earmarking returns with invalid TINs for additional review. Also, although Sec. 6723 imposes a $50 penalty for failing to provide a valid TIN, TIGTA found this penalty was rarely imposed and, when it was, it was assessed for $5 rather than the statutory amount due to faulty programming.

Despite the increase in discrepancies and the IRS's earlier agreements in response to TIGTA's findings, the Service has examined only a small and dwindling number of these returns, TIGTA stated. In fiscal 2010, the IRS selected 13,594 returns with alimony deductions for examination, which fell to 7,492 in fiscal 2016, which were approximately 5.1% and 3.2%, respectively, of the returns with alimony income that TIGTA identified as having a discrepancy with a corresponding deduction.

In its response to these latest findings, IRS management pointed out that the number of taxpayers reporting alimony could decrease as a result of the TCJA's repeal; TIGTA pointed out in return that although the number of taxpayers reporting alimony likely will not increase, the number continuing to report it under pre-2019 agreements and decrees will likely remain sizable for the foreseeable future.

TIGTA also noted that although it recommended in its earlier audit that the IRS increase its use of "soft" notices to taxpayers with alimony discrepancies, the IRS has not done so; TIGTA disagreed with several reasons IRS managers put forth for why soft notices (which are issued to taxpayers for informational purposes to tell them they may have an error on their return) are not feasible.

In response to this audit, the IRS agreed to monitor and revise its filters for selecting returns for examination, to improve its monitoring of TINs and processing of returns with invalid TINs, and to properly assess penalties for failure to provide a valid TIN.

[ITEM 9] Nora L. Mihelick v. United States of America

Reversing a district court, the Eleventh Circuit Middle District Court of Florida held, on June 18th, that a taxpayer was entitled to a deduction under Sec. 1341(a) based on her payment to her ex-husband, under the couple's separation agreement, of her share of the settlement of a lawsuit involving compensation her ex-husband earned while they were married.

Background

Nora Mihelick and Michael Bluso married in Ohio in 1978. From 1999 to 2004, Bluso was the CEO of Gotham Staple Co., a closely held company owned by his family, and received compensation for his work at Gotham.

In September 2004, Mihelick filed for divorce. While the divorce was pending, Pamela Barnes, one of Bluso's sisters and a minority shareholder in Gotham, sued Bluso, Gotham, and others, claiming, among other things, that Bluso had breached his fiduciary duties by excessively compensating himself at Gotham's expense.

Bluso thought that Mihelick should have to pay half of any liability from the lawsuit, but Mihelick did not. However, under pressure from Bluso, Mihelick signed a separation agreement that provided that any liability from the Barnes litigation would be considered a marital liability for which Bluso and Mihelick would be jointly and severally liable. In 2005, the couple's divorce was finalized.

In 2007, Bluso settled with Barnes. Under the terms of the settlement, Bluso disclaimed any wrongdoing but agreed to pay Barnes $600,000 to settle her excess-compensation claims. Bluso paid the full $600,000 to Barnes.

Bluso expected Mihelick to pay him $300,000 to cover her half of the settlement payment per their separation agreement, but, despite the terms of the agreement, Mihelick initially refused to do so. However, after her lawyer advised her that she was obliged to make the payment, Mihelick gave in and paid Bluso $300,000 in 2009.

Bluso took a tax deduction for $300,000, his share of the settlement payment to Barnes, and the IRS allowed the deduction. Mihelick, feeling that she was in the same position as Bluso, took a deduction for her payment to Bluso in 2009 and claimed a refund as a result of the deduction. She asserted that she was entitled to the deduction under Sec. 1341 because the payment to Bluso was a restoration of an amount she had previously included in income under a claim of right. The IRS denied the deduction and her claim for a refund. In response, Mihelick filed a refund suit in district court.

Under Eleventh Circuit precedent, Sec. 1341 does not, by itself, create an independent tax deduction and applies only if another Code section would provide a deduction for the item in the current year. Mihelick argued that she was entitled to deduct the $300,000 payment under Sec. 165(c)(1) as a loss incurred in a transaction entered into for profit not connected with a trade or business. She claimed that the repayment of income from prior years was clearly a loss and she entered into the transaction to repay past income to be released from further liability.

The court disagreed, finding that Mihelick made the payment under a private settlement agreement and not because of any personal obligation resulting from Barnes's lawsuit; consequently, she did not have a loss from a transaction entered into for profit. Thus, the court held that she was not entitled to a deduction in 2009 for the payment under Sec. 1341.

Mihelick appealed the decision to the Eleventh Circuit, again arguing that she was entitled to a deduction under Sec. 1341 and Sec. 165(c).

The Eleventh Circuit's decision

The Eleventh Circuit reversed the district court and held that Mihelick was entitled to a deduction in 2009 under Sec. 1341. Following its decision in Florida Progress Corp., 348 F.3d 954 (11th Cir. 2003), the court employed a four-part test to determine whether Sec. 1341 applied to Mihelick's payment to Bluso.

1) A taxpayer must show that the item of income was included in a prior year's gross income because it appeared that the taxpayer had an unrestricted right to the item of income.
2) The taxpayer must establish that, after the close of the tax year in which the income was reported as taxable income, he or she actually did not have an unrestricted right to that income.

3) The amount of income the taxpayer did not have an unrestricted right to must exceed $3,000, and,
4) It must be deductible under another Code provision. If the taxpayer qualifies for relief under Sec. 1341, he or she can deduct the item from the current year's taxes or claim a tax credit for the amount his or her tax was increased in the prior year by including that item.

The IRS did not dispute that the amount of the deduction Mihelick claimed exceeded $3,000. Therefore, the court only addressed the remaining three elements of the test in making its decision.

Appearance of an unrestricted right to income: The IRS argued that Mihelick did not appear to have an unrestricted right to the income in question because she had no presumptive right to Bluso's income. Further, it asserted that even if she did have a presumptive right to the income, she did not have an unrestricted right to the income because Bluso could not have claimed an unrestricted right to the income he allotted himself from Gotham if he misappropriated those funds.

The Eleventh Circuit found, after reviewing Ohio statutory law and case law on the point, that Mihelick presumptively had the same right to the income at issue as Bluso. Moreover, it made no difference whether Mihelick had a presumptive right to Bluso's income because she only needed to have a sincere belief that she had a right to the income. Based on the evidence in the record, the court found that she did sincerely believe she had a right to the income.

The Eleventh Circuit agreed with the IRS that Bluso would not have had an unrestricted right to the income if he had misappropriated it because he would not have had a sincere belief that he had an unrestricted right to the income. However, since the settlement agreement in the Barnes lawsuit expressly disclaimed any wrongdoing on Bluso's part, the court said there was no proof that he had misappropriated the income, so the IRS's argument that he did not believe he had an unrestricted right to the income failed.

<u>Proof there was not an unrestricted right to income</u>

To prove the second requirement was met, the Eleventh Circuit stated that, based on its precedent, the taxpayer must demonstrate that he or she involuntarily gave away the income in question because of some obligation, and the obligation had a substantive nexus to the original receipt of the income.

Because the record showed that Mihelick had reasonably anticipated litigation and settled in good faith in the shadow of litigation, the court concluded her payment to Bluso was involuntary for purposes of Sec. 1341.

The court also determined that the substantive nexus between Mihelick's obligation to pay and the receipt of the original income was straightforward. The court found that the $300,000 presumptively was marital property earned equally by Mihelick and Bluso. The fact that the couple took the $300,000 as income was also the reason Barnes brought her lawsuit — to recover money that was allegedly wrongfully paid to them. Because Bluso and Mihelick agreed to split the $600,000 liability from Barnes's lawsuit, Mihelick paid the $300,000 in settlement of the claim, and therefore Mihelick's payment ultimately stemmed from the original receipt of the income at issue.

<u>Deductible under another provision of the Code</u>

The Eleventh Circuit concluded that this element was satisfied because Mihelick was entitled to a deduction under Sec. 165(c)(1) for losses incurred in a trade or business. Under the Tax Court's decision in Butler, 17 T.C. 675 (1951), a corporate officer may deduct the amount to settle a bona fide suit alleging mismanagement of corporate affairs if the allegations are directly connected with the taxpayer's business activity. According to the court, the rule from Butler applied in this case because Bluso was in the trade or business of being a fiduciary and employee of Gotham, and Barnes's suit was a bona fide suit for breach of trust or mismanagement of funds by Bluso in his capacity as a fiduciary and an employee of the company. Thus, the $600,000 settlement in the case was a deductible loss for Bluso.

In the court's view, this characterization of Bluso's settlement payment to Barnes carried over to Mihelick's payment to Bluso, because, as the court had already determined, Mihelick was presumed under Ohio law to have contributed equally with Bluso to the production and acquisition of the income from Gotham, so she was presumed to have contributed equally to the liability from the lawsuit. The payment of the liability from the lawsuit was deductible under Sec. 165(c)(1), and she had helped create the liability, so she was entitled to a deduction under Sec. 165(c)(1) for her payment of half the liability.

<u>Reflections</u>

The district court and the Eleventh Circuit came to different conclusions in this case because the district court considered the payment to Bluso to be due to Mihelick and Bluso's execution of the separation agreement in their divorce, while the Eleventh Circuit considered it to be due to the settlement of the Barnes lawsuit. Given that Mihelick, who was not a party to the Barnes lawsuit, was not required to make any payment as a result of the lawsuit and was only required to make the payment under the property settlement provisions of the separation agreement, the district court would seem to at least facially have a better argument. Nonetheless, the Eleventh Circuit came up with a creative way to reach what can be considered an equitable result.

[ITEM 10] MyPayrollHR

A worst-case scenario is currently unfolding in upstate New York. The cloud-based payroll processing firm, MyPayrollHR allegedly vanished with nearly $35 million in payroll funds from customers, directly impacting employees who had been receiving direct deposits from the firm on a bi-weekly basis. Not only did money from payroll funds disappear, but also cash funds belonging to individual employees. The FBI is currently investigating, seeking answers from company affiliates and having impacted business owners fill out online questionnaires in its efforts to identify any details relevant in this case.

In a message posted on its Twitter page, the FBI's Albany field office stated that it was "seeking information from business owners who may have suffered financial loss due to the alleged activity of MyPayrollHR and its affiliates."

MyPayrollHR abruptly abandoned its offices in Clifton Park, north of Albany, in early September and sent its 4,000 clients an automated message that said it was "no longer able to process any further payroll transactions," according to the Albany Times Union.

The message blamed "unforeseen circumstances" and advised companies to "find alternative methods for processing your payrolls."

As a result, thousands of workers had automatic payroll deposits withdrawn from their bank accounts, with some suffering multiple withdrawals, according to reports. Many had their balances wiped out — or even plunged into the red.

Gov. Andrew Cuomo said MyPayrollHR's "reckless actions have left employees across the state and the nation with negative bank balances" and vowed that "we will not allow these bad actors to take money away from the hard-working people in this state."

Albany-based Pioneer Bancorp (and related entity Pioneer Bank) told federal regulators that it "recently became aware of fraudulent activity by an established business customer."

A lawyer for Cachet Financial Services, which handled individual payroll disbursements for MyPayrollHR, said she spoke briefly with Michael Mann, CEO of MyPayrollHR, after a planned $26 million deposit was diverted from Cachet's holding account to a Pioneer Bank account on Sept. 4th, according to the Krebs On Security website.

According to Cachet, Mann promised to call Cachet back within a few minutes but never did. On September 16th, FBI agents searched the upstate New York home of Mann. arriving at his lakeside house in Edinburg, armed with a federal search warrant to search and collect potential evidence.

As of this writing, MyPayrollHR's website doesn't address the situation and its phone number leads to several automated messages, including one in which a robotic voice says, "We are sorry, no one is available to take your call. Please try again later."

Trust Fund Penalty for Unpaid Payroll Taxes

The MyPayrollHR saga serves as a painful reminder to all practitioners that incurring the trust fund penalty is a very real risk and undoubtedly one of the more onerous tax provisions in the code.

The tax code imposes on several groups of persons the responsibility to collect, account for and pay over to the government various taxes imposed on other persons. These are commonly known as "trust fund" taxes because §7501(a) says that the money so collected is held in trust for the United States until it is paid over. Two of the most important trust fund taxes are the income and social security withholding taxes.

Section 3402(a) makes every employer responsible for withholding their employees' income taxes. Section 3102(a) imposes a withholding requirement for the employees' share of social security taxes. Employers are supposed to remit these withheld taxes on an ongoing basis and to account for the payments and withholding once each quarter on Form 941.

Section 6672 is a penalty designed and administered to help ensure payment of trust fund taxes. It provides that the Service may impose a penalty on any "person"—which term can include individual employees as well as the employer—who, "under a duty" to collect a trust fund tax, "willfully fails to collect such tax, or truthfully account for and pay over such tax." The penalty amount is 100% of the tax owed. In short, a company owner or officer, or another "responsible person," may be held personally liable for any unpaid payroll taxes.

Responsible Person

The requirements of the "Responsible Person" cannot be understated. The trust fund penalty may be assessed against any person who:

- Is responsible for collecting or paying withheld income and employment taxes or for paying collected excise taxes, and
- Willfully fails to collect or pay those taxes.

Typically, this liability is imposed on a company owner or president, but it potentially could extend down the ranks to a mid-level manager or bookkeeper.

A responsible person for these purposes is any person — or group of people — who has the duty to perform and the power to direct the collecting, accounting and paying of trust fund taxes. Accordingly, the IRS says this could be:

- An officer or employee of a corporation,
- A member or employee of a partnership,

- A corporate director or shareholder,
- A board of trustee's member of a not-for-profit organization,
- Someone with authority and control over funds to direct their disbursement,
- Another corporation or third-party payer,
- Payroll Service Providers (PSP) or responsible parties within a PSP,
- Professional Employer Organizations (PEO) or responsible parties within a PEO, or
- Responsible parties within the common law employer (PSP/PEO client).

The IRS has a broad definition of "willful failure." The failure doesn't have to be intentional. For example, the trust fund penalty may be applied in situations where someone knew, or should have known, about the taxes that should have been paid, but weren't. In other words, the penalty may be imposed on someone regardless of their intentions.

The IRS is allowed to pursue more than one person for this tax obligation. In a recent Third Circuit Court of Appeals case, USA v. Darren Commander, the court imposed the trust fund penalty against a corporate co-owner even though it was the other owner who was responsible for payroll. The U.S. Supreme Court has declined to review the appeals court's decision, so the decision stands.

<u>USA v. Darren Commander</u>

In Darren Commander, a trial court granted summary judgment against a 50% owner of a woodwork fabrication and installation business.

He and his co-owner (who died during the court proceedings) formed the woodworking company in New Jersey in 2003. They were the sole officers and owners. All decisions and actions, as well as most significant financial transactions, could only be made with the consent of both parties. However, the other co-owner was responsible for hiring field employees, assigning employees to each job, ensuring work was completed in the field, recording hours worked and distributing paychecks to employees.

From 2007 through 2009, the company failed to pay income and employment taxes for its employees even though workers were being paid. The IRS imposed trust fund penalties totaling $1.6 million against the defendant in 2010.

The trial court granted summary judgment to the government. It concluded that there is no factual dispute that the defendant was a responsible person who willfully failed to pay the company's taxes. In support of this decision, the court noted that:

The defendant was a 50% owner and one of two officers of the company. His approval was required for all company decisions and actions and many significant financial transactions, and he had check-signing authority and power to pay the company's bills and sign paychecks.

The defendant argued that his co-owner was solely responsible for paying the taxes. But the court found this to be irrelevant because the defendant was, in fact, a responsible person. The court concluded that the defendant had actual knowledge, or should have known, that the taxes weren't being paid and that he acted willfully within the meaning of the trust fund penalty provision.

The appeals court rejected the defendant's arguments and upheld the trial court's grant of summary judgment for the government. Critical to the court's decision: Liability for the trust fund penalty can be extended to more than one person.

The appeals court also dismissed the defendant's claim that he had originally misspoken in saying that he was aware of the tax deficiencies during the tax years in question and actually learned of it "later." The court determined that the defendant didn't produce any evidence to substantiate this assertion. Finally, it disagreed with the defendant's complaint that he wasn't granted sufficient opportunity to prove his arguments.

<u>Letter of the Law</u>

If the IRS determines in a payroll tax dispute that an individual is deemed a responsible person, then it will issue a letter stating that it plans to assess the trust fund penalty against that individual. They will then have 60 days (75 days if the letter is sent to an address outside the U.S.) from the date of the letter to appeal. This communication will explain appeal rights available to the individual. In the event that an individual does not respond, the IRS will assess the penalty against the individual and send a Notice and Demand for Payment.

Once the trust fund penalty is assessed, the IRS can take collection action against personal assets which includes filing a federal tax lien, take levy or seizure action.

<u>Conclusion</u>

- $26 million in lost wages
- $35 million when including taxes
- 4,000 companies impacted
- Untold number of employees & families have been affected.
- **<u>Stay Vigilant!</u>**

<u>REVIEW QUESTIONS AND SOLUTIONS**</u>**

7. The TCJA increased bonus depreciation from ___________ for qualified property placed in service after ______.
   a. 50% to 100%, December 31, 2017

b. 0 to 100%, December 31, 2017
c. 50% to 100%, September 27, 2017

8. Rev. Proc. 2019-33 provides relief to taxpayers contemplating a decision to elect ________ .
   a. Bonus Depreciation
   b. The Centralized Partnership Audit Regime
   c. A change in fiscal year

9. If a divorce decree was duly executed _________ December 31, 2018, then alimony paid by the payer is __________.
   a. after, deductible
   b. before, deductible
   c. before, not deductible

10. Sec. 1341 of the IRC applies when an item of income reported in an earlier tax year (at a higher tax rate) is returned in a subsequent year (at a lower tax rate). In the Nora L. Mihelick v. United States of America case, the court employed a four-part test to determine whether Sec. 1341 applied. This included determining whether the taxpayer ___________.
    a. Did not include the item of income in a prior tax period
    b. Expatriated during the tax year
    c. Had income which exceeded $3,000

11. According to the IRS, in connection with the remittance of trust fund taxes, a Responsible Person could be _________.
    a. An officer of a corporation
    b. A Payroll Service Provider
    c. Both A & B

12. Section 6672 is a penalty designed and administered to help ensure payment of trust fund taxes. It provides that the IRS may impose a penalty on any "person" who, "under a duty" to collect a trust fund tax, "willfully fails to collect such tax, or truthfully account for and pay over such tax.". The IRS defines "willful failure", in part, to state that _________ .
    a. the failure does not have to be intentional
    b. motive must be present to establish willful failure
    c. unlawful intent and financial gain must be present

Solutions

7. **[a] Incorrect -** On September 13th, the IRS issued final regulations (T.D. 9874) and new proposed regulations (REG-106808-19) governing the 100% bonus depreciation deduction under Sec. 168(k).
   [b] Incorrect - Bonus depreciation is also allowable for specified plants planted or grafted after Sept. 27, 2017, and before Jan. 1, 2027.
   [c] Correct - The TCJA allows businesses to immediately deduct 100% of the cost of eligible property in the year it is placed in service, through 2022.

8. **[a] Correct -** Some taxpayers requested relief to make late elections for property placed in service during tax years that included Sept. 28, 2017, because they had already filed their federal returns for that tax year before the proposed regulations were issued or did not have time to analyze the effect of the proposed regulations and make a timely election.
   [b] Incorrect - The centralized partnership audit regime under the Bipartisan Budget Act of 2015 (BBA) became effective for partnerships with tax years beginning after Dec. 31, 2017. This new regime significantly impacts how the IRS audits partnership tax returns and collects any resulting taxes.
   [c] Incorrect - Rev. Proc. 2019-33 allows taxpayers to revoke or make late bonus depreciation elections for property acquired after Sept. 27, 2017 and placed in service or planted or grafted, as applicable, during a taxable year that includes Sept. 28, 2017.

9. **[a] Incorrect -** TIGTA stated in its latest report that the IRS still lacked sufficient systemwide processes to identify and address alimony discrepancies and "has yet to adequately address the substantial compliance gap" they represent.
   [b] Correct - Taxpayers claiming an alimony deduction are required to provide the tax identification number (TIN) of the recipient.
   [c] Incorrect – Alimony payments based on pre-2019 divorce agreements continue to be deductible by the payer.

10. **[a] Incorrect -** A taxpayer must show that the item of income was included in a prior year's gross income
    [b] Incorrect – Residency was not called into question in this case.
    [c] Correct - The IRS in this case did not dispute that the amount of the deduction Mihelick claimed exceeded $3,000.

11. **[a] Incorrect –** Employees of a corporation could also be considered for this designation.
    [b] Incorrect – Responsible parties within a Payroll Service Provider organization could also be a responsible person.
    [c] Correct – A responsible person has the duty to perform and the power to direct the collecting, accounting and paying of trust fund taxes.

12. **[a] Correct -** In other words, the penalty may be imposed on someone regardless of their intentions.
    [b] Incorrect - the trust fund penalty may be applied in situations where someone knew, or should have known, about the taxes that should have been paid, but weren't.
    [c] Incorrect - The IRS is allowed to pursue more than one person for this tax obligation.

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******* EXAM QUESTIONS *******

*Place your answers to the following 20 Multiple Choice Questions on the enclosed answer sheet (**page 21**).*

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1. A business will meet the "gross receipts test" of section 448(c) when it has average annual gross receipts of ________or less in the previous __________.
   a) $10 million, 2 years
   b) $25 million, 2 years
   c) $10 million, 3 years
   d) $25 million, 3 years

2. An eligible real property trade or business or farming business may elect to be an excepted trade or business by following the procedures outlined in §1.163(j)-9 of the proposed regulations. Taxpayers making this election to be an excepted real property trade or business are also subject to a restriction on assets, specifically the method of depreciation. Taxpayers making this election depreciate assets using ____________ .
   a) The alternative depreciation system (ADS)
   b) The modified accelerated cost recovery system (MACRS)
   c) The accelerated cost recovery system (ACRS)
   d) Straight line depreciation

3. Which of the following statements is true concerning carryovers and disallowed interest under section 163(j)?
   a) Disallowed interest must be used within five years from the year of disallowance.
   b) The disallowed business interest expense carryforward may be limited in the next taxable year if the section 163(j) limitation continues to apply.
   c) Disallowed interest can be carried back to previous years to reduce taxable income.
   d) None of the above

4. According to the 2009 Social Security Trustees Report, if the combined OASDI trust fund becomes exhausted in 2034, benefit reductions of around _____ percent or payroll tax increases will be required.
   a) 15
   b) 20
   c) 25
   d) 30

5. The projected increase in the cost of the OASDI program from 2010 to 2030 is mainly attributable to?
   a) the change in the ratio of beneficiaries to the number of workers
   b) a decline in birthrates
   c) an increase in the National Debt
   d) an increase in the Normal Retirement Age

6. Which of the following court cases in this newsletter addressed the issue of tax refunds and lookback periods?
   a) Borenstein v. Commissioner
   b) Nora L. Mihelick v. United States of America
   c) USA v. Darren Commander
   d) Crosby v. Nash

7. According to code section 6512(b), A taxpayer who files a return and is issued a notice of deficiency within three years after that filing is entitled to a lookback period of at least _______ years.
   a) two
   b) three
   c) four
   d) five

8. Which of the following Supreme Court cases stated that a corporation exists for tax purposes if it formed for a business purpose or carries on a business activity?
   a) National Alfalfa Dehydrating & Milling Co., 417 U.S. 134 (1974)
   b) Moline Properties, Inc., 319 U.S. 436 (1943)

c) Texas v. Johnson, 1989
d) Dillon v. Gloss, 256 U.S. 368 (1921)

9. T.C. Memo. 2002-287, states that a shareholder's payments of a corporation's expenses are a loan or contribution of capital to the corporation, and, if deductible, are deductible by ___________ .
   a) The shareholder
   b) The corporation
   c) Both parties
   d) Neither party

10. IR 2019-151 spells out relief provisions afforded to certain individuals who expatriate from the United States. The relief applies to individuals who relinquished or will relinquish their U.S. citizenship after _________ .
    a) January 1, 2010
    b) January 1, 2018
    c) March 18, 2010
    d) March 18, 2018

11. Taxpayers eligible for relief in accordance with IR 2019-151 include?
    a) Individuals
    b) Estates
    c) Trusts
    d) Corporations

12. According to the TCJA, allowable bonus depreciation for property placed in service in 2023 is ______.
    a) 80%
    b) 60%
    c) 40%
    d) 20%

13. Final Treasury Department regulations are usually effective during tax years that include the date _________ .
    a) Preceding the year of release
    b) They are published in the Federal Register
    c) Based upon the temporary regulations
    d) Of the press release

14. Rev. Proc. 2019-33 was recently released allowing taxpayers to __________ .
    a) Revoke or make a late bonus depreciation election
    b) Elect CPAR for an existing partnership
    c) Claw back unused carryover losses from a previous filing year
    d) Retroactively change a placed in-service date for assets acquired after Sept 27, 2017

15. A recent report issued by the Treasury Inspector General for Tax Administration (TIGTA) highlighted discrepancies between the amount of alimony deducted by payers and the amount reported as income by its recipients. Based on this report, IRS management stated that ____________ .
    a) Projected taxpayer compliance is expected to increase resulting from tax simplification
    b) An increase in "soft notices" issued by the IRS should alleviate this issue
    c) TIGTA has no jurisdiction in the matter
    d) the number of taxpayers reporting alimony could decrease as a result of the TCJA's repeal

16. Which of the following steps is the IRS implementing to reduce taxpayer discrepancies between the amount of alimony deducted by payers and the amount reported as income by its recipients?
    a) monitor and revise its filters for selecting returns for examination
    b) improve its monitoring of TINs and processing of returns with invalid TINs
    c) properly assess penalties for failure to provide a valid TIN
    d) All of the above

17. In the case of Nora L. Mihelick v. United States of America, the Eleventh Circuit court concluded that _________ .
    a) Mihelick was entitled to a deduction under Sec. 1341(a) based on her payment to her ex-husband

b) Mihelick was denied a deduction since the payment was not related to a trade or business
c) The plaintiff had no claim resulting from her unrestricted right to the income in question
d) The plaintiff's husband could not deduct his share of the settlement

18. Section 6672 is a penalty designed and administered to help ensure payment of trust fund taxes. The penalty amount is __________ of the amount owed
    a) 25%
    b) 50%
    c) 75%
    d) 100%

19. Which of the following would be considered "trust fund" taxes?
    a) Estimated tax payments made by an employee
    b) Excise tax payments made by a corporation
    c) Social Security taxes withheld from an employee
    d) FUTA taxes remitted by an employer

20. If the IRS determines in a payroll tax dispute that an individual is deemed a responsible person, then it will issue a letter stating that it plans to assess the trust fund penalty against that individual. How many days will the individual have to file an appeal?
    a) 60 days from the date of the letter
    b) 90 days from the date of the letter
    c) 60 days from the date the letter is received
    d) 90 days from the date the letter is received

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4. ________	8. ________	12. ________	16. ________	20. ________

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